

## Franchise Tax Board

## ANALYSIS OF ORIGINAL BILL

Author: Kelley Analyst: Marion Mann DeJong Bill Number: SB 1920  
Related Bills: See Legislative History Telephone: 845-6979 Introduced Date: 02/24/2000  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Manufacturers' Investment Credit/Extends to Major Group of Other Electric Power Generation

SUMMARY

Under the Bank and Corporation Tax Law (B&CTL), this bill would modify the Manufacturers' Investment Credit (MIC) to include taxpayers engaged in businesses relating to electric power generation.

EFFECTIVE/OPERATIVE DATE

The bill would be effective immediately upon enactment and specifies that it would apply only to income years beginning on or after January 1, 2000.

LEGISLATIVE HISTORY

**SB 671 (Ch. 881, Stats 1993)** added the MIC to the Revenue and Taxation Code. **SB 676 (Ch. 751, Stats. 1994)** made clarifying changes to the MIC. **SB 975 (Ch. 91, Stats. 1995)** was a code maintenance bill; it made technical changes to the MIC. **SB 38 (Ch. 954, Stats. 1996)** expanded the MIC by: (1) adding semiconductor equipment manufacturing and certain aerospace manufacturing to the definition of "qualified taxpayer" for the special purpose building provision; and (2) adding taxpayers engaged in certain biopharmaceutical and biotech activities to the definition of "small business." **SB 1106 (Ch. 604, Stats. 1997)** was a clean-up bill for SB 38; it made technical changes to the MIC. **AB 2798 (Ch. 323, Stats 1998)** extended the MIC to manufacturers of custom or prepackaged computer software. **SB 1229 (Ch. 987, Stats. 1999)** made clarifying changes needed as a result of AB 2798.

SPECIFIC FINDINGS

**Existing state and federal laws** generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a business or investment property. The property must have a limited, useful life of more than one year and includes equipment, machinery, vehicles and buildings, but excludes land. Property is assigned to specific classifications related to the number of years of its useful life. The property then may be depreciated over the number of years of its useful life (recovery period).

**Existing state and federal laws** allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business.

## Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

## Department Director

## Date

Gerald H. Goldberg

3/20/00

**Existing state law** allows qualified taxpayers a manufacturers' investment credit equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California.

For purposes of the MIC, a qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes in the SIC Manual. Qualified property is any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code (IRC) and used primarily:

- for manufacturing, processing, refining, fabricating or recycling of property;
- for research and development;
- for the maintenance, repair, measurement, or testing of otherwise qualified property; or
- for pollution control which meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) Special purpose buildings and foundations that are an integral part of specified activities.

For taxpayers engaged in computer programming and computer software related activities, qualified property includes computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software, and (2) the value of any capitalized labor costs directly allocable to such property.

The MIC provides a variety of special rules for costs paid pursuant to a binding contract and leased property. The credit may be carried over until exhausted, for a maximum of eight years. For small businesses, this carryover period is extended to ten years. The taxpayer must recapture any credit previously allowed if the property is removed from California, disposed of to an unrelated party or converted to an unauthorized use within one year from the date the property is first placed in service in California.

Certain "new businesses" (as defined) may claim an exemption from sales and use tax instead of this tax credit. The existing sales and use tax law also allows a taxpayer to claim a refund for the sales or use tax that was paid on the purchase of qualified property rather than claiming the MIC, subject to certain special rules relating to amount and timing of the refund.

**Under the B&CTL, this bill** would include businesses relating to electric power generation in the definition of "qualified taxpayer" for the MIC. These activities are described in North American Industry Classification System (NAICS) Manual Code 221119, as follows:

Establishments primarily engaged in operating electric power generation facilities (except hydroelectric, fossil fuel, nuclear). These facilities convert other forms of energy, such as solar, wind, or tidal power, into electrical energy. The electric energy produced in these establishments is provided to electric power transmission systems or to electric power distribution systems.

**This bill** would modify the definition of "manufacturing" to include the production of electricity from one or more of the following energy sources: solar, wind, geothermal, solid-fuel biomass, waste tire, municipal solid waste, digester gas, or hydropower with a generating capacity of 30 megawatts or less.

**This bill** also would modify the binding contract rules in the MIC so that purchases of equipment pursuant to a binding contract entered into before January 1, 1998, by taxpayers engaged in other electric power generation would not qualify for the credit. The bill would also change the dates in the election provision for certain leases of MIC qualified property.

#### Policy Considerations

This bill would raise the following policy considerations.

- Although this bill would modify the binding contract rules in the MIC, it may not be limited to future business decisions since it does not exclude purchases of qualified property made by a binding contract that existed after January 1, 1998, but prior to the date of enactment of this bill.
- This bill would not expand the MIC for Personal Income Tax law (PITL) taxpayers engaged in business relating to other electric power generation, creating inconsistent application of the MIC between PITL and B&CTL taxpayers. In addition, in the case of any MIC that is passed through from an S corporation to the shareholders, the shareholders would not be eligible to claim the credit.

#### Implementation Considerations

This bill would raise the following implementation considerations. Department staff is available to assist the author with any necessary amendments.

- This bill does not modify the definition of qualified property to include property used in businesses relating to other electric power generation. Thus, taxpayers added by this bill would qualify for credit only if their property qualified under current law. This would limit the availability of the credit and may lead to disputes between taxpayers and the department.
- This bill does not make a corresponding change to the MIC under the PITL, which may cause taxpayer confusion. Taxpayers that are shareholders of an S corporation may be especially confused since the credit could not flow from the S corporation to the shareholder. This could lead to disputes between taxpayers and the department.

- This bill would expand the definition of manufacturing to include the production of electricity from specified energy sources. As a result, taxpayers who qualify for the MIC under existing law could claim the MIC for auxiliary activities that satisfy this expanded definition of manufacturing; for example, a manufacturing plant that includes on its premises a co-generation facility that produces electricity to run the manufacturing line. Under current law, this co-generation facility is properly treated as an auxiliary establishment under the SIC Manual and is assigned the same SIC Code as the manufacturing activity and would not qualify under the current definition of manufacturing. However, such activities would qualify under the manufacturing definition provided by this bill. If the author did not intend to expand the credit available to taxpayers currently qualified for the MIC, the bill should be amended so the expanded definition of manufacturing applies only to NAICS Code 221119.

#### Technical Considerations

Amendments 1 and 2 would remove the phrase "the amendments made by the act adding this subdivision shall be operative" and insert the correct citation for the specific laws that changed the MIC.

#### FISCAL IMPACT

##### Departmental Costs

This bill would not significantly impact the department's costs.

##### Tax Revenue Estimate

The revenue losses under the B&CT laws are estimated to be as follows:

Revenue Impact of SB 1920		
For Taxable/Income Years Beginning		
01/01/2000		
Assumed Enactment After 6/30/2000		
Fiscal Years		
(In Millions)		
2000-01	2001-02	2002-03
-\$5	-\$8	-\$9

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal.

##### Tax Revenue Discussion

The revenue impact of this credit would depend on the amount of qualified costs incurred and the tax liability of qualified taxpayers.

Qualified costs were estimated from an U.S. Census Bureau survey of capital expenditures by industries in SIC codes 4911, 4931 and 4939 -for 1997. Qualified costs were then factored down to reflect NAICS Code 221119, which is a industry subgroup of the above SIC codes.

The 1997 numbers were grown to approximate year 2000 and beyond. The credit use rates taken from the microsimulation model of California tax returns were then applied to derive the aggregate credit use. The fiscal year cash flow patterns are based on FTB analysis of how manufacturers adjusted their tax payments to reflect the reduction in liability resulting from the current law MIC.

This estimate does not include losses resulting from qualified taxpayers as defined under current law that might receive additional credit for activities that would qualify under the definition of manufacturing provided by this bill (discussed in implementation considerations). Such losses can not be quantified since the taxpayers engaged in the production of electricity, but whose primary business is manufacturing cannot, be identified.

#### BOARD POSITION

Pending.

Marion Mann DeJong  
(916) 845-6979  
Patrick Kusiak

FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO SB 1920  
As Introduced February 24, 2000

AMENDMENT 1

On page 15, modify lines 3 and 4 as follows:

(j) The amendments made by ~~the act adding this subdivision~~ Chapter 954 of the Statutes of 1996 shall be operative for income years beginning

AMENDMENT 2

On page 15, modify lines 7 and 8 as follows:

(k) The amendments made by ~~the act adding this subdivision~~ Chapter 323 of the Statutes of 1998 shall be operative for income years beginning